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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 127, No. 128

FEDERAL POWER COMMISSION,

Petitioner,

and

MEMPHIS LIGHT, GAS AND WATER DIVISION,

Petitioner,

vs.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE-LINE COMPANY OF AMERICA, and TEXAS EASTERN TRANSMISSION CORPORATION,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

JOINT BRIEF OF RESPONDENTS, TEXAS EASTERN TRANSMISSION CORPORATION AND NATURAL GAS PIPELINE COMPANY OF AMERICA.

OPINIONS BELOW.

The opinion and order of the Federal Power Commission (Commission) herein (31 F.P.C. 1180; II R. 70-72) was reversed by the United States Court of Appeals for the Fifth Circuit (357 F.2d 230, II R. 70-72). That Court's opinion, which is here under review, cited *Cities Service Gas Co.* v. *FPC,* 337 F.2d 97 (10th Cir., 1964), which also reversed the Commission's decision in 30 F.P.C. 158 (1963), on the same issue.

These two appellate reversals are the only Courts of Appeals decisions on the so-called "consolidated effective tax rate" issue which is involved herein. In each case, at the Commission level, the reversed decisions were issued by three Commissioners, with two dissenters.

QUESTION PRESENTED.

The United States Court of Appeals for the Fifth Circuit, concurring with the decision of the United States Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *FPC*, 337 F.2d 97 (1964), held that the Commission exceeded its statutory jurisdictional authority when, in setting rates to be charged by a natural gas pipeline company subject to its jurisdiction, the Commission reduced the "tax allowance" (and thus the rates) for that jurisdictional company by taking into account losses of other subsidiaries of the same parent corporation which were incurred in operations not subject to the Commission's jurisdiction. The question presented is whether the Commission, in setting rates for a company partially subject to Commission jurisdiction, is authorized to take into account the tax effect of profits earned and losses sustained in non-jurisdictional activities of affiliated companies that join with the partially jurisdictional company and its parent corporation in filing a consolidated federal income tax return.

STATEMENT OF THE CASE.

I. THE PARTIES

United Gas Pipe Line Company (United), whose rates were in issue in the proceedings below before the Commission, operates a natural gas pipeline system. Less than one-half of United's sales of gas are made in interstate commerce for resale, and are thus subject to Commission jurisdiction. More than one-half are made in intrastate commerce, and are thus exempt from Commission jurisdiction.

United is a wholly-owned subsidiary of United Gas Corporation (Parent Corporation), which owns and operates natural gas distribution systems in various areas of Texas, Louisiana and Mississippi and is not subject to regulation by the Commission in any degree. Parent Corporation purchases about 6½% of the gas sold by United, which comprises approximately 96% of Parent Corporation's gas purchases.

Parent Corporation is also the parent of Union Producing Company (Union), a company engaged in the exploration for, and development and operation of, both natural gas and oil production properties. *None* of Union's oil sales, and only the *interstate* portion of its natural gas sales, are subject to Commission jurisdiction. United purchases approximately 11% of its natural gas requirements from Union, which represents approximately 80% of Union's gas sales.

Parent Corporation is also the parent of United Overseas Production Corporation (Overseas), a corporation participating in an oil exploration project in Tunisia,

North Africa, which, like Parent Corporation, is not subject to Commission jurisdiction in any degree.

For purposes of paying federal corporate income tax, Parent Corporation, United, Union, and Overseas (Corporate Group) form an affiliated group that joins in a consolidated tax return filed by Parent Corporation.

Respondents Natural Gas Pipeline Company of America (Natural) and Texas Eastern Transmission Corporation (Texas Eastern) are natural gas pipeline companies which make jurisdictional purchases of gas from United and which participated in the subject rate case of United before the Commission in order to guard against unjustified rate increases to them and their customers. Petitioner Memphis Light, Gas and Water Division (Memphis) is a local distributor of gas which purchases gas from a company which purchases part of its supply from United.

II. COMMISSION PROCEEDINGS

In its rate case before the Commission, out of which these review proceedings arose, United followed the traditional method, under "cost-of-service" regulation, of including, as a component of its rates to its jurisdictional customers, an amount reflecting reimbursement of federal income taxes computed at 52% of anticipated jurisdictional income. Fifty-two percent (52%) was, of course, the actual, lawful statutory tax rate in effect during the test year for the rate case.(*)

(*) In 1964, the tax rate was reduced to 50% and to 48% for 1965 and thereafter. The rate was 52% in the years relevant to these proceedings, however (subject to surtax adjustment, which is ignored here for simplicity).

The Commission ignored the statutory tax rate and, relying on its own decision in *Cities Service Gas Co.*, 30 F.P.C. 158 (1963), (subsequently reversed, *Cities Service Gas Co.* v. *FPC*, 337 F.2d 97 (10th Cir., 1964)), rejected United's use of the normal public utility computation of a reasonable tax allowance, based on the statutory 52% of income. Instead, the Commission computed a lesser federal income tax allowance by utilization of tax reductions and losses attributable to the unrelated, nonjurisdictional and non-utility operations of affiliated companies, by means of what it referred to as its "consolidated effective tax rate" method. The Commission, below, said that the issue before it, which is now before this court, was as follows:

> A question is raised as to United's share of the federal income tax paid through a consolidated tax return filed by United Gas Corporation, its parent. Joined in the return are the subsidiaries, United, Union, and United Overseas Production Corporation. In most years Union shows a loss with a resulting reduction in taxes for the consolidated group. However, United contends that it is entitled to apply to its taxable income the statutory income tax rate in computing the amount of federal income taxes includible in its cost of service unreduced by utilization of tax reductions and losses attributable to the unrelated, nonjurisdictional and non-utility-operations of affiliated companies.
>
> The question here involved has already been determined by us in *Cities Service Gas Company*, 30 FPC 158, Opinion No. 396, Docket No. G-18799, issued July 15, 1963.(*)

(*) 31 F.P.C. at 1190, II R. 41 (footnote omitted). The mechanics of the Commission's computation are set forth in the opinion of the Court of Appeals for the Tenth Circuit in *Cities Service Gas Co.* v. *FPC*, 337 F.2d 97 (1964), and are discussed later in this Joint Brief.

The Commission then proceeded to reduce the amount of federal income taxes in United's cost of service by the same computation prescribed in *Cities Service.*

The mechanics of the Commission's computation under this method are such that the Commission ignored company boundaries, grouped as regulated companies, companies which are outside its jurisdiction under the Natural Gas Act, "apportioned" the total intercompany group tax liability among the companies of the group, and then used the amount of tax so apportioned to United to "calculate" the "consolidated effective tax rate" which the Commission used to reduce United's jurisdictional rates. Basically, under this method, what the Commission did was to utilize tax losses created by the unrelated and non-jurisdictional operations of Union and Overseas to reduce the income tax allowance to be allowed in United's cost of service, for the benefit of its jurisdictional customers. No part of the expenses which produced the losses of Union and Overseas, and no part of the losses themselves, were, of course, used by the Commission in setting United's rates.(*) Inclusion of such items would have increased United's rates.

III. COURT OF APPEALS PROCEEDINGS

United, Natural and Texas Eastern appealed the Commission's decision to the United States Court of Appeals for the Fifth Circuit. That court reversed, consistent with the Tenth Circuit's decision in *Cities Service Gas Co.* v. *FPC,* 337 F.2d 97 (1964), stating that:

(*) Nor were factors relative to Parent Corporation, which had no losses.

> We do not think there are any such fact differences between *Cities Service* and this case as call for the application of any different rule of decision. The Court in the Tenth Circuit case held that the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed. We think the Tenth Circuit case is correct and that the principles which are announced in its opinion are here applicable and controlling. The Commission's order, using an incorrect income tax rate in computing cost of service for the fixing of United's gas rates is erroneous and must be
>
> Vacated and set aside.(*)

In *Cities Service,* the Court of Appeals held the Commission's "consolidated effective tax rate" technique invalid on the grounds, *inter alia,* that it produced a legally fallacious "tax rate" for the regulated company, Cities Service Gas Company, and that such rate was produced by the use of tax losses of companies which were outside the jurisdiction of the Commission, thus violating the jurisdictional limits which Congress wrote into the Natural Gas Act.

(*) 357 F.2d at 231.

SUMMARY OF ARGUMENT.

The Commission, in its zeal to continually devise new theories to reduce pipeline rates, has created a "consolidated effective tax rate" method which has the effect of reducing the *interstate* pipeline rates of United, which rates are subject to the Commission's jurisdiction, *because other, non-jurisdictional subsidiaries of United's parent suffer losses, and even though such subsidiary loss operations are not subject to Commission jurisdiction.* United, and Respondents Natural and Texas Eastern, oppose the Commission's invalid, one-sided theory and contend, instead, for application of the normal rate-making procedures which are consistently applied in fixing jurisdictional rates of natural gas companies—calculation of the rate making "tax allowance" by use of the actual statutory corporate income tax rate.

The only two Courts of Appeals which have considered this question have each reversed the Commission—the Fifth Circuit, below, in *United Gas Pipe Line Company, et al* v. *FPC*, 357 F.2d 230 (5th Cir. 1965), and the Tenth Circuit, in *Cities Service Gas Company* v. *FPC*, 337 F.2d 97 (10th Cir. 1964). In the only other case in which the Commission has considered the question involved herein, the Commission rejected the "consolidated effective tax rate."(*) Other Commission cases cited by Petitioners are not in point, since they deal with different facts and theories.

(*) *Olin Gas Transmission Corp.*, 17 F.P.C. 695 (1957).

The Solicitor General has admitted, explicitly in the Petition For Certiorari herein and, implicitly, in the Commission's brief, that "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group",(*) but has attempted to defend the Commission's decision on the basis that *some* method of "allocation" of the *Corporate Group's* total tax would be valid in setting *United's* rates. This conclusion is, of course, irrelevant, since this Court is faced with two specific judicial reversals of a specific invalid action by the Commission. This is not an advisory opinion proceeding.

Beyond that, however, the Solicitor General's conclusion is invalid. No "allocation" of the Corporate Group's tax is valid in these situations, because income tax liability is not a "joint cost" which is subject to "allocation". It is a specific cost which is incurred separately by each individual corporate entity. The responsibility of each operating entity for an income tax expense is separately determined and that amount can be, and under even-handed application of normal regulatory principles, should be, directly *assigned* to that entity. No "allocation" is required or permissible.

Even if an "allocation" were held to be permissible, however, it is also true that the version of the Commission's "consolidated effective tax rate" which is here under review is not a valid method. First, the essence of the

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(*) Fn. 8, p. 10 of the Petition For a Writ of Certiorari filed herein by the Commission.

procedure is to reduce the rates of United by using losses suffered by other subsidiaries of United's parent, including, and even limited to, *losses suffered in operations not subject to Commission jurisdiction,* such as Union's extensive *oil* exploration, production and sales, and the operations of Overseas, conducted entirely outside the United States. This involves a reaching by the Commission far beyond its jurisdictional power, not only to take away benefits which belong to, and are produced by, those non-jurisdictional companies, but also to have the jurisdictional rates of United depend upon the profits or losses of non-jurisdictional operations of those other companies. Such jurisdictional violation is invalid under repeated decisions of this Court. See, for example, *Panhandle Eastern Pipe Line Co.* v. *FPC,* 324 U.S. 635 (1945) and other cases cited in Section II-A of Argument, *infra.*

Second, the Commission's "allocation" of tax, apart from jurisdictional questions, also is inconsistent with the basic principles of regulatory law, which it otherwise follows, with regard to United, that only the operations of the entity whose rates are being set may be considered in compiling costs to fix those rates. The Commission honors this by setting separate rates, in separate rate cases, for United and Union. Yet now the Commission has violated these principles, selectively, in the "consolidated tax" area. The arguments raised in support of this violation by Petitioners, Commission and Memphis, attempt to justify the Commission's action on the basis of claims that United and Union (ignoring Overseas) are "related." Those claims, however, even if they were all correct, are not sufficient to validate the jurisdictional and "regulatory separation" violations. In addition, most of those

claims are unsupported in the record or in the Commission's findings and many of the claims are inaccurate, and others irrelevant in this context, as is demonstrated in detail in Section II-B of Argument, *infra*. These include the attempt to refute the conclusive fact that the consolidated tax return here produced no overall saving to the Corporate Group, and that the inclusion of United in the group consolidated tax return *increased the tax of the Corporate Group by an amount equal to the full 52% of United's taxable income.*

Finally, the Commission's "consolidated effective tax rate" method is in contravention of the purpose of Congress in authorizing the filing of consolidated tax returns. That purpose is to allow corporate systems which include companies with losses to make current use of those losses to reduce current taxes, thus providing current funds and incentive to encourage risk taking. But the Commission's "consolidated effective tax rate" method takes those funds, and thus that incentive, away by reducing United's rates.

ARGUMENT.

INTRODUCTION

This case presents an extreme example of Federal Power Commission attempts to reduce the rates of natural gas pipeline companies, which has led the Commission to unlawful action. In carrying out its regulatory responsibilities, the Commission has twisted, and ignored, not only the jurisdictional limits upon it, but also the regulatory principles which the Commission applies in all other situations—avoidance of "allocation" of costs when direct "assignment," upon the basis of a determination of responsibility, is possible; separation of rate determinations, and rate structures, for different types of operations; and the necessity to give effect to the intention of Congress in allowing consolidated income tax returns.

In doing this, the Commission has developed an artificial technique. The one-sided purpose of that technique is shown by its "one-way" effect—that under the Commission's method, a "consolidated effective tax rate" will be applied to pipeline rate-making only if it produces a "tax rate" which is *lower* than the statutory rate. As the Commission itself states, its "allocation" of tax applies only "*provided* that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, if computed on a separate return basis."(*)

The Commission's one-sided psychology is at least hinted at on page 22 of the Commission's brief herein, with the

(*) *Cities Service Gas Co.*, 30 F.P.C. 158, 164 (1963).

statement that "We need not go so far as to suggest that as partners, the ratepayers were entitled to share in the profits produced by the oil operations." Even to suggest this possibility, even though seeming to reject it, is to exhibit the Commission's lack of concern for legal and equitable limitations, which has produced a tax "allocation" method that *does,* in fact, appropriate a portion of non-jurisdictional oil losses for reduction of jurisdictional rates. And it must be noted that the Commission's procedure is based on the fundamental inequity that it does not increase United's rates because United's fellow subsidiaries have more expenses than income; but does decrease United's rates because of the tax effect of those losses suffered by the fellow subsidiaries.

Although the Commission itself may think it has produced a viable "allocation" method, the Solicitor General obviously doesn't share that attitude. Instead, the Solicitor General (Brief, p. 15) takes great pains to argue that the question involved here is not whether the *type* of "allocation" imposed upon United by the Commission is valid, but rather whether *any* "allocation" which might be designed could be valid. And in the Commission's Petition For a Writ of Certiorari herein (fn. 8, p. 10) the Solicitor General admits that:

> There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the *entire tax saving* resulting *from losses on unregulated* activities to the *regulated* members of the consolidated group. (Emphasis added)

Thus, this Court is being asked to uphold the Commission's decision, which reduces United's rates and income, and to reverse the Fifth and Tenth Circuit Courts of

Appeals on the basis that the Commission *might* be able to produce a valid "allocation" method in the future. For the reasons outlined in this brief, Natural and Texas Eastern do not believe the Commission could devise such a valid method. There are too many inherent defects in their theories.

But that is not the question. What is here under review is a Commission decision which is clearly invalid. It is so extreme that it produces the anomalous result that when the non-jurisdictional operations of the Parent Corporation's other subsidiaries produce *losses, United's* rates are *reduced.* But United's rates would not be reduced if those non-jurisdictional fellow subsidiaries had profits. Apart from considerations of legality, this is not even reasonable.

United merely wishes to have its rates computed by the normal principles of ratemaking. Its rejection of the "consolidated effective tax rate" method does not increase its rates over what they would normally be. Those rates simply would not be reduced by the Commission's invalid theory.

I.

THE COMMISSION'S "ALLOCATION" OF TAXES WAS UNNECESSARY AND ERRONEOUS.

As described earlier, the Commission action which was reversed by the court below (as was an identical action in *Cities Service*) was the creation of the Commission's own "tax rate" for the jurisdictional pipeline, the substitution of that rate in place of the higher, actual statutory tax rate, and the use of that new, lower rate to calculate the tax allowance portion of the "cost of service" from which the rates of the pipeline are derived. The result of

such actions was to reduce the jurisdictional rates of the pipeline.

The method used by the Commission starts with the total tax liability of the entire Corporate Group of which United is a part, "allocates" the total tax among the companies in the group, without regard to the source of the taxable income which results in such total tax, and then compares the tax so "allocated" to United to the taxable income of United, to compute the Commission's own "consolidated effective tax rate."

The premise of the Commission's theory is that an "allocation" of tax is necessary, and the Commission devotes the "Introduction" of its Argument (Commission Brief, pp. 12-15) to an attempt to convince this Court that an allocation of the total Corporate Group tax was required in order to determine United's tax allowance. In fact, however, no allocation was required or permissible, for the following reasons.

A cost "allocation" is a division of costs on some "reasonable" estimated basis. An "assignment" of costs is simply a determination that a given cost was incurred for or caused by a given operation and thus is to be "assigned" to that operation on the basis of responsibility. Thus, where there are costs which must be divided among operations, the more precise "assignment" is used first, and the more imprecise "allocation" estimates are to be used only with regard to "joint costs" which cannot be assigned.

The Commission itself recognized the above elementary facts in this present case, stating:

> We think it a desirable principle of rate making that costs should be directly assigned whenever feasible,

and cost allocation with all of its complexities should be employed only when necessary.(*)

Despite the above facts, the Commission continues to allege that an "allocation" of tax liability is necessary. To try to prove this, the Commission, at page 12 of its Brief, attempts to use examples and points to "rent paid by *the concern* for occupancy of a building housing both pipeline and non pipeline employees", and the salary it pays its "comptroller who keeps all the books of *the concern*" (emphasis added) as examples of "joint costs" which *must* be "allocated." In actuality, such items, considered in the abstract way in which they are posed by the Commission, may or may not be "joint costs," and thus an allocation may or may not be needed. In this regard, it is significant that the costs are referred to, in the Commission's brief, as quoted above, as costs of "the concern." What if there are, as in the United system, several "concerns", each housed in the same building? Could not the building owner charge each corporation separately for rent for the portion of the building occupied by each corporation? In that case, no "allocation", between the corporations, of the total rent is needed. If but one rental bill is rendered for the entire building, however, then an allocation is required.

Similarly, the comptroller could sign an employment contract which provided that he be paid separately by *each* corporation. In that case, no allocation of his total salary would be needed. If his contract provided for one undifferentiated payment, however, and he served more than one corporation, or operation, then his salary must be "allocated."

(*) 31 F.P.C. at 1197 (II R. 48).

The Commission's examples of the need for allocation of cost *savings* (at page 13 of its Brief)—refunds of a portion of the rent or of the comptroller's salary—give equally uncertain results. Again, the Commission did not go far enough in its analysis. Just as with "joint costs" themselves, savings of, or reductions in, "joint costs" must be allocated *if they are attributable to both pipeline and non-pipeline operations.* Thus, it is the *reason* for a reduction or saving which is crucial in deciding whether an allocation is appropriate.

Assume that the landlord who refunds a portion of the rent does so because certain employees of the oil operations of the non-pipeline affiliate move to other quarters and give up use of part of the building. In that case, the "reduction" or "saving" in rent clearly would be assignable directly to the oil operations without "allocation". Similarly, suppose that the comptroller, in the Commission's example, returns a portion of his salary, not because it was paid by mistake, but because he no longer performs certain duties formerly carried on for the *non-pipeline* affiliate. Should that "reduction" or "saving" in salary expense be allocated, in part, to the *pipeline,* in that case? Obviously not. The reason is that in both of the above cases the "reduction" or "saving" is wholly attributable to one of the divisions or affiliates, and there is no need to "allocate" that "saving." Rather, the saving should be *assigned* to that particular division or affiliate which causes the saving.

In light of the above analysis, the Commission's assertions as to the need for "allocation" of the total Corporate Group income tax liability may be seen to be clearly inaccurate. Each company in the Corporate Group in which United is a subsidiary incurs its *own* tax deductible ex-

penses and earns its *own* income. And each company's income tax, which results from the application of the statutory rate to its own net taxable income is reported separately on an income tax return to form the basis for the Corporate Group consolidated tax liability.(*) These *separate* corporate tax computations are cumulated in the consolidated group tax return. Thus, it is not only separately computable, it is obvious, what effect each corporation in the group has on the consolidated tax. United, for example, had taxable profits in each of the five test years. Therefore, its inclusion in the consolidated returns increased the total system tax by 52% of United's taxable income. And that 52% amount is a finite, separately determinable and determined cost of United, which the Commission should have "assigned" to United's "cost of service." There was no need to "roll" United's tax into the total system tax and then "allocate" a portion of the total *group* tax back to United.

Exactly the same thing is true when we deal with consolidated tax "savings." If a company with a taxable loss is included in a consolidated tax return, its loss will be set off against the profits of other companies. Thus, in the particular year in which the loss occurs, the taxable income of the overall consolidated group is less than the sum of the taxable profits of the companies which have profits, because the losses of the "loss companies" are deducted from those profits. This causes what appears, in the first instance, to be a "saving" in tax for that year.(**)

(*) 26 C.F.R. 1.1502-31(b)(1), (2)—applicable to taxable years before 1966.

(**) But see Section III-B2 of Argument, *infra*.

That "saving," however, is wholly attributable to the losses of the "loss companies" in the group—in these proceedings, to the losses produced by the non-jurisdictional activities of United's fellow subsidiaries—and is in no way attributable to United and its ratepayers. Just as the above described rebate in rent, occasioned by a decrease in space contracted for by a *particular* division or affiliate, or a "refund" of salary, occasioned by decreased duties performed for a *particular* division or an affiliate, is directly assignable to that division or affiliate, so are *tax losses* incurred by a *particular* division or affiliate assignable to *that* division or affiliate.

Thus, it can be seen that both the portion of the tax of the Corporate Group which is caused by United's jurisdictional operations, and the tax "saving" caused by other companies in the system, are directly ascertainable and thus can be "assigned" to those companies. There is, therefore, neither necessity nor justification for an "allocation" of total group tax—the separate tax liabilities can be directly ascertained, so that there is no need to start with the total, and attempt to decide upon an "equitable" allocation.

This is what the Tenth Circuit held in *Cities Service* (adopted by the Fifth Circuit in *United*, below) when it said:

> We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported

to the parent Company, and the consolidated returns actually reflect that tax liability.(*)

Thus, the first basic premise of the Commission's argument—that an "allocation" of tax is proper at all—is shown to be erroneous.

It is also true, however, that even assuming, *arguendo*, that an allocation were required, the Commission's "allocation" is invalid because it inevitably exceeds the Commission's jurisdictional power, ignores the separate business activities within the consolidated Corporate Group, is based on the erroneous premise that tax "savings" are created by use of a "consolidated return" and violates the purpose of Congress in enacting the consolidated tax provisions of the Internal Revenue Code. These facts will be shown in succeeding sections of this brief.

II.

THE COMMISSION'S ACTION EXCEEDS ITS JURISDICTIONAL AUTHORITY.

A. A Fundamental Principle Of Rate Regulation Under The Natural Gas Act Requires The Commission To Separate Jurisdictional And Non-Jurisdictional Expenses.

A fundamental principle of rate regulation under the Natural Gas Act, articulated by this Court in *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U.S. 635 (1945), for example, requires the Commission to disregard the profits and losses of non-jurisdictional activities in considering just and reasonable rates for the service rendered by a jurisdictional company or operation. The reasons for this are obvious. Users of a public utility service should not be forced to bear the cost of non-jurisdictional opera-

(*) 337 F.2d at 100.

tions or enterprises, nor should they have any right to share in the profits of non-jurisdictional divisions or affiliates of a utility group, via lower rates.

But the "consolidated effective tax rate" method, as applied by the Commission in this case, which is analyzed hereinbelow in subsection B of this Section II, produces just that prohibited result. Use of that theory in rate-making by the Commission has the inevitable effect of assigning the current income tax reductions, which result from the losses of non-jurisdictional operations of affiliates, to United and its ratepayers. This is in violation of the holding of this Court, in *Panhandle*, that:

> We agree that the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rates of a company whose activities embrace both. *Otherwise, the profits or losses, as the case may be, of the unregulated company would be assigned to the regulated business and the Commission would transgress the jurisdictional lines* which Congress wrote into the Act. (Emphasis added)(*)

Further, the Commission itself, in its decision below, recognized the vitality of that principle and acknowledged its duty to abide by it.(**) But while it followed that principle in determining all other elements of United's jurisdictional cost of service, it wholly failed to do so in fixing United's income tax allowance.

(*) 324 U.S. at 641-42. See also, for example, *Panhandle Eastern Pipe Line Co.* v. *Public Service Commission of Indiana*, 332 U.S. 507, 516 (1947); *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 503 (1949); *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581 (1945).

(**) 31 F.P.C. at 1190-91 (II R. 41-42).

B. The Commission's Method In This Case Improperly Credits United's Rates With Reductions In Tax Expense That Are Wholly Attributable To The Non-Jurisdictional Activities Of United's Affiliates.

The effect of the Commission's "consolidated effective tax rate" method, which violates the principles shown in the preceding subsection herein, is to use the reduction in income tax resulting from losses of companies outside the jurisdiction of the Commission to reduce the rates which United is allowed to charge for the portion of its services which are subject to the Commission's jurisdiction. Commission Staff counsel admitted, at the hearings below, that this was the effect of the consolidated effective tax rate,(*) and Petitioners and Respondents are in agreement with regard to the facts which prove the conclusion that it is non-jurisdictional tax losses of other companies which are used to reduce United's rates—that it is the deduction of the tax losses of the non-jurisdictional operations in the group from the jurisdictional profits, which allows the mathematics of the Commission's method to produce a "consolidated effective tax rate" lower than 52%,(**) which, in turn, reduces the jurisdictional revenues of United.

That is what happened in *Cities Service,* and the Commission applied, in this case, the method it first advanced

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(*) At I R. 120, he "stipulated" that the reduced "tax rate" applied to United resulted from "taking into account Union's losses on oil as well as Union's losses on gas."

(**) See 357 F.2d at 231, 30 F.P.C. at 164 and 31 F.P.C. at 1190.

in *Cities Service*. The Commission recognizes that its method uses non-jurisdictional losses to reduce jurisdictional rates and has expressly stated, as noted earlier, "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group." (p. 10, fn. 8, Commission Petition For a Writ of Certiorari herein.)

And that is just what happened below. Under the formula used by the Commission, practically all of the tax losses of Overseas, which resulted from its non-jurisdictional oil activities outside the United States, and of Union, which resulted from Union's unrelated and non-jurisdictional activities, were used to reduce United's income tax allowance in its cost of service and, thus, its jurisdictional rates. To use these unrelated and non-jurisdictional tax losses to reduce United's jurisdictional rates plainly transgresses the jurisdictional limitations which Congress wrote into the Natural Gas Act. Just as the Commission cannot regulate the rates of non-jurisdictional companies, or non-jurisdictional activities, directly, it cannot do so indirectly by appropriating "non-jurisdictional" tax losses through the device of reducing United's "jurisdictional" rates because of such losses. This device, like direct regulation of the non-jurisdictional "loss companies", reduces Corporate Group income because of the non-jurisdictional operations of Union and Overseas, which the Commission is not empowered to affect. And the "consolidated effective tax rate" device would make the tax allowance, and hence the jurisdictional rates of United, vary depending upon the taxable profits or losses

of the non-jurisdictional affiliates, which is equally invalid.(*) As the Tenth Circuit held, in reversing the Commission's "consolidated effective tax rate" method in *Cities Service*:

> We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. See: Colorado Interstate Gas Co. v. F.P.C., supra; Panhandle Eastern Pipe Line Co. v. F.P.C., supra; Wisconsin v. F.P.C., 373 U.S. 294, 83 S. Ct. 1266, 10 L. Ed. 2d 357. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which

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(*) United points out in its brief that all of Union's tax losses result from its oil operations—that Union's natural gas operations produced taxable income. Even if, however, both the jurisdictional and non-jurisdictional operations of Union had produced losses, it would still be true that *all* losses of Union, under the Commission's method, as well as the wholly non-jurisdictional losses of Overseas, would have the effect of reducing United's rates. The Commission's theory would, under those conditions too, violate the Commission's jurisdictional power, since some non-jurisdictional losses would be seized and used to reduce the jurisdictional rates of United.

Congress wrote into the Act." Panhandle Eastern Pipe Line Co. v. F.P.C., supra, 324 U.S. pp. 641, 65 S. Ct. p. 285.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.(*)

C. Even The Commission's Supposed "Regulated," "Non-Regulated" Categories Demonstrate The Commission's Violation Of Its Jurisdictional Powers.

The Commission's "consolidated effective tax rate" method involves, as the Commission stated in its *Cities Service* opinion, the following steps:(**)

(*) 337 F.2d at 100-101. At the Commission level, two of the five Commissioners, Messrs. Woodward and O'Connor, dissented from the Commission's *Cities Service* decision, stating: "[T]he majority view is unlawful because it has the effect of regulating non-utility enterprises beyond the Commission's jurisdiction; . . ." (30 F.P.C. at 172)

(**) 30 F.P.C. at 164 (repeated by the Commission in *United*, below, 31 F.P.C. at 1190).

> . . . (1) separate the companies [which join in filing a consolidated return] into *regulated and unregulated groups,* (2) determine the aggregate taxable income of *each group,* and (3) apportion the net total consolidated tax liability over a representative period of time between the *two groups* . . . (Emphasis added)

Thus, the meaning of "regulated" group and "unregulated" group is central to the Commission's method. But the Commission's definition of "regulated" and "unregulated" ignores its jurisdictional limits. The Commission uses "regulated" to mean regulated by *some* agency, but not necessarily by the Federal Power Commission. Thus, even when acting within the bounds of its own "regulated" category, the Commission exceeds the limits of its jurisdiction. This is made clear at 31 F.P.C. at 1190-91, where the Commission stated that it had classified United Gas Corporation (the parent of United) as a regulated company because it "engages in the distribution of gas and its rates are variously subject to regulation *by state commissions and municipalities.*" (Emphasis added).(*) It can be seen, therefore, that the method used by the Commission has, as its first steps, a procedure which ignores the jurisdiction of the Commission itself and deals with

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(*) The Commission, in its attempt to find any way to reduce pipeline rates, is not even consistent in its categorization of companies. Thus, Union, although its interstate sales of gas are subject to Commission jurisdiction, seems to be classified as "unregulated," although the Commission seems ambivalent and even goes so far as to say it does not really make any difference how Union is classified. (31 F.P.C. at 1191)

an irrelevant category—the category of companies subject to regulation by some agency.(*)

The Natural Gas Act limits the regulatory authority of the Commission to the transportation and/or sale of natural gas in interstate commerce for resale.(**) The Act does not give the Commission regulatory authority over the local distribution of gas, nor does the Act give the Commission regulatory authority over any aspect of the oil business or over the affairs of a company engaged in overseas exploration for gas and oil. The Courts of Appeals for the Tenth and Fifth Circuits properly have held that the consolidated effective tax rate method of apportionment of the total tax liability among the regulated companies, devised by the Commission in *Cities Service* and used by it in the proceedings below, fails to comply with those jurisdictional requirements.

(*) It should be noted that had the Commission's method used *jurisdictional* and non-jurisdictional separation, the non-jurisdictional profits would have more than offset the non-jurisdictional losses. That would have meant that even under the Commission's method, United's tax rate would not have been reduced. Therefore, the Commission simply reshaped its own method to get a desired result, but exceeded its jurisdictional power in the process. See Exhibit 36, II R. 24.

(**) 15 U.S.C. §717(b).

III.

EVEN APART FROM JURISDICTIONAL VIOLATIONS, THE CLAIMS OF "PRACTICAL" JUSTIFICATION BY THE COMMISSION ARE ERRONEOUS AND ALSO CANNOT OVERCOME THE FACT THAT THE OPERATIONS OF THE AFFILIATED COMPANIES ARE SEPARATE FROM THOSE OF UNITED.

A. The Commission Violated Principles Of Regulatory Law Which The Commission Otherwise Follows.

In dealing with the Corporate Group of which United is a part, the Commission follows the basic principle that the identity of the entity being regulated in a given case must be determined, and only the operations of that entity may be considered in determining its rates. Where jurisdictional questions are involved, then such separation of operations is even more imperative. In setting the rates of United, for example, the Commission must, and does, separate costs between United's own jurisdictional interstate sales and its non-jurisdictional intrastate sales. The Commission, quite properly, does not include, as a cost to be paid by United's interstate customers, any of the costs and expenses of carrying on United's non-jurisdictional operations. Further, the Commission does not impose on jurisdictional ratepayers the costs incurred by non-jurisdictional affiliated companies.

Even when no question of Commission jurisdiction is involved, however, separate operations must be honored. The Commission knows this and normally follows that principle. For example, the interstate natural gas operations and sales of *both* United and Union are regulated by the Commission. Nevertheless, the Commission respects the separate operations and separate operational and corporate identities of the two affiliated companies, and does

not attempt to regulate the companies together. Each company has a separate rate structure, and their rates are fixed in wholly separate rate cases.(*) There is no mixing.

However, the Commission violated these principles in its "consolidated effective tax rate" method. Not only is it beyond the Commission's jurisdiction, but it is also completely unreasonable for the Commission to attempt to use *affiliates'* losses to reduce *United's* rates, for "consolidated" expenses bear no reasonable relationship to the actual expenses incurred by United. Those expenses are incurred in relation to, and are needed to earn, the actual separate company income of United. Yet the Commission would cut the rates, and thus the income, of United, but its expenses would not be reduced. And the Commission would ignore the fact that there is no equitable or legal basis for the Commission to give the jurisdictional customers of United the benefits of *any* losses which result from the businesses of its affiliates. None of the costs and expenses of the affiliates—jurisdictional or not, and regulated or not—were included by the Commission in United's jurisdictional cost of service.

Thus, in this proceeding, except for the income tax allowance included in United's cost of service, the Commission has stayed within proper lines and fixed United's jurisdictional rates solely on the basis of its own jurisdictional costs, expenses and revenues. Thus, in determining United's jurisdictional cost of service, the Commission quite properly did not include *any* of the costs and expenses of United's non-jurisdictional operations or of con-

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(*) See, for example, the proceedings of United, below, 31 F.P.C. at 1187-89, and the separate proceedings of Union, *Union Producing Co.*, 31 F.P.C. 41 (1964).

ducting the businesses of United's affiliates. However, in devising the "consolidated effective tax rate" method, the Commission, while recognizing the fundamental rate-making principle which requires the recognition of separate profits in the determination of the tax allowance, has failed to comply, either in *Cities Service* or in these proceedings, with that requirement. Instead, the Commission has reduced United's rates because of the tax losses of separate, albeit affiliated, companies, which carry on separate kinds of operations. It is completely illogical to take into account tax losses of separate affiliates and operations, and not give affect to the revenues and expenses which create those losses. The Commission cannot—and did not—do the latter, yet it did the former.

B. The Claims Of "Practical" Justification By The Commission And Memphis Are Both Insufficient And Erroneous.

The Commission ignores the jurisdictional question and, instead, devotes 12 of the 16 pages of its Argument (Brief, pp. 12-23) to an attempt to justify its actions by answering only the point demonstrated in subsection A, above, by arguing that United and its affiliates are really not separate operations at all and thus are entitled to "share" each other's tax losses. The brief of Petitioner Memphis, too, finds it difficult to use the word "jurisdiction". Instead, Memphis also devotes the greater part of its Argument to claims that United and its affiliates are so interrelated as to justify the Commission's procedures.

Those "practical" claims of "interrelation"—which are advanced by the Commission and Memphis in an attempt to justify the use of tax losses of United's fellow subsidiaries to reduce the rates of United—will be specifically

answered in this section. First, however, it is necessary to note two points:

(1) Even if all of such claims of interrelation between affiliates were correct, they could not justify the jurisdictional violation which necessarily results from the Commission's "consolidated effective tax rate" method. When a regulatory agency acts beyond the boundaries of the authority granted to it by Congress and this Court, its action cannot be made lawful by claims of "practical" justification.

(2) Apart from jurisdictional considerations, it is also true that even if the "practical" arguments of the Commission and Memphis were correct, they could not justify the use of non-pipeline tax losses (and the income and expenses, of the other companies, which produced those losses) to reduce United's pipeline rates.

Natural and Texas Eastern will now turn to consideration of the accuracy of the legally insufficient "practical" arguments of the Commission and Memphis.

1. *Classification Of Union As "Regulated" And "Related" Is Both Meaningless And Inaccurate.*

Memphis first devotes Section I, pages 17-20, of its brief to creating and defeating a straw man argument. That is, Memphis repeats the portion of the third paragraph of the opinion of the Tenth Circuit in *Cities Service*(*) which asks whether the Commission could use the "losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company." Memphis then goes on to try

(*) 337 F.2d at p. 98.

to prove that Union, as a corporate entity, is "regulated" and "related." This, however, is pure straw man tactics, because the *holding* of the Court of Appeals(*) was *not* that the Commission's method was unlawful because Union was not "regulated" and "related"—it was that such method was unlawful because it violates the *jurisdictional* authority of the Commission by using losses of "nonregulated businesses" to reduce the tax allowance of the company whose rates the Commission is examining. In this jurisdictional context, it is clear that the Tenth Circuit, when it says "nonregulated," means "not subject to Federal Power Commission jurisdiction," not the "regulated by *someone*" definition created by the Commission.

Even if the *general* "regulated" and "related" status of Union(**) were the central point in the Tenth Circuit's decision, however, it is clear that Union does not qualify. As to "regulation," none of Union's oil operations are regulated by anyone. Memphis argues that Union's oil is largely produced from *fields* which also produce gas, and seems to suggest that this changes Union's unregulated status as to oil. It does not, and Memphis does not point out why it thinks it does, or should. But Memphis does misleadingly imply that gas consumers pay oil exploration

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(*) 337 F.2d at pp. 100-101.

(**) Overseas, of course, is not subject to regulation by any agency, so that the Memphis argument is wholly inapplicable to Overseas. Memphis and the Commission try to pass off, as *de minimus*, the use of the losses of "nonregulated" Overseas to reduce United's rates. Yet, it is the Commission which wants this Court to rule *only* on the question of principle behind its "consolidated effective tax rate" theory. If only "principle" is involved, even true *de minimus* examples are relevant.

costs, when in fact, the Commission, in fixing Union's jurisdictional rates, separates out all non-jurisdictional oil costs and the gas consumers pay only the costs fairly apportioned to jurisdictional *gas* exploration, production and sales. And United does not buy Union's oil. Further, Union's non-jurisdictional gas operations are also not regulated by the Commission.

Memphis ends up by arguing that *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (5th Cir., 1960), requires approval of the Commission's "consolidated effective tax rate" method. The simplest answer to this argument is that the Fifth Circuit decided both *El Paso* and *United*, below, and obviously disagreed with Memphis. The Court did not even mention *El Paso* in *United*. The reason is clear. First, of course, no consolidated tax return or "effective tax rate" was involved in *El Paso*. But beyond that, *El Paso* held that the pipeline must consider *its own* tax deductions which arise from its own jurisdictional gas operations, in calculating *its own* tax allowance for *gas* rates, but the case did not, as does the instant proceeding, involve the use of the tax losses of other companies, which arise from non-jurisdictional operations of those other companies, including oil operations, to reduce the pipeline's jurisdictional gas rates.(*)

2. *The Claim That United's Profits Are Necessary To Use Non-Jurisdictional Losses Is Both Inaccurate And Irrelevant.*

The briefs of both the Commission (pp. 16-17) and Memphis (p. 22) also argue that United's rates should be reduced by the losses of Union and Overseas because,

(*) *El Paso Natural Gas Co.*, 22 F.P.C. 260 (1959).

under the consolidated tax return procedure, the profits of United are necessary in order to gain tax saving benefits from those losses. First, this is irrelevant to jurisdictional questions. Second, the claims are not true, because there are more than enough non-jurisdictional profits in the group to absorb those losses. Parent Corporation, in fact, alone had enough profits to do just that.(*) Finally, Petitioners' claim seems to suggest that a consolidated tax return is the only way to utilize tax losses. In fact, it is not, so that Petitioners err by assuming that a group of corporate affiliates receives an overall tax "saving" by filing a consolidated return rather than separate returns. That error may be explained as follows. Income earned by a large corporation during a particular period of time—the taxable year—is taxed at a 52% rate.(**) An ungraduated income tax administered in this way will produce, over a period of several years, a tax of exactly 52% of the corporation's income for those years, if the corporation has income in each year. This is not necessarily true, however, when a corporation has incurred losses in some of those years. In that case, unless those losses are somehow credited, for tax purposes, against the income realized during the profitable years, the sum of the taxes paid by the corporation will exceed an amount warranted by the actual profits of the corporation. For example, if a corporation were to have income of $1,000,000 in the first year, losses of $1,000,000 in the second year, and profits of $1,000,000 in the third year, strict adherence to a "taxable year" concept would

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(*) See Commission Brief, p. 6; II R. 53.

(**) The recent change in tax rate does not change the results described here.

result in the corporation paying no tax in the second year and being taxed at a 52% rate on the profits of the first and third year, so that $2,000,000 would be taxed. Viewed realistically, however, the corporation had profits of only $1,000,000 for the three year period. Thus, strict adherence to the "taxable year" concept in such a situation would result (at a 52% rate) in the corporation paying more taxes than it had income.

In recognition of this fact, Congress provided, in Section 172 of the Internal Revenue Code of 1954,(*) "carrybacks" and "carryovers" which allow corporations experiencing alternating periods of profit and of loss to pay taxes that realistically reflect actual income over a period of time longer than the "taxable year." Losses incurred in one year are used to reduce income, and consequently taxes, in other years. For example, in the above hypothetical situation, the corporation would be allowed to adjust its income for tax purposes in the first year by the amount of its loss in the second year, thus cancelling out its income for the period. While this method has the disadvantage of not necessarily accurately matching the tax payable in a particular year with income for that year, it does insure that the taxpayer will be assessed, over a reasonable period of time, a tax representing no more than 52% of its actual overall income. No "saving" is involved. The taxpayer is not taxed at a rate less than 52% as a result of the carryover and carryback provisions of the Code. Those provisions simply decrease what would otherwise be an excessive tax, of more than 52% of actual income, to a 52% figure.

(*) 26 U.S.C. §172.

The filing of a consolidated return by an affiliated group has exactly the same effect. Under the consolidated return procedure embodied in Sections 1501-1504 of the Code,(*) eligible corporations may pay a tax each year that is computed on the basis of the income of the entire group, rather than on the separate incomes of the affiliates. As a result, losses incurred by any one of the corporations reduces the income on which the tax is imposed, in the same year that the loss is incurred. Thus, actual consolidated income of the group is taxed at a 52% rate for that period, rather than at the higher actual rate, which would result from failure to include the losses. Taxes are therefore "reduced."

That reduction does not give anyone any "saving," however. On the contrary, the effect of the utilization of a consolidated return is merely to reduce what would otherwise be an excessive tax of more than 52% of actual income to a 52% figure. While this same result can be obtained on a separate return basis, by taking advantage of carryover and carryback credits, the use of the consolidated return has the additional advantage of allowing losses to be reflected in taxes for the year in which the losses were incurred, rather than in preceding or subsequent years.

The Commission, however, has proceeded on the theory that the use of a consolidated return results in an overall tax "saving," because one of the members of the group had a tax loss. In doing so, it ignored uncontradicted expert testimony to the effect that if it had needed to do so, Union could have, and would have, utilized any carry-

(*) 26 U.S.C. §§1501-1504.

over or carryback credits it might have acquired during the test period. As Mr. Dunn, an accountant with a broad background in matters of this nature, testified:

> I have made a study . . . and that study proves conclusively that whether a consolidated return basis is used or a separate return basis is used, Union, itself, can use all of its tax deductions.(*)

Thus, the Commission ignored *two facts*: First, that a corporation like Union can control the years of its profits and losses to take advantage of its tax credits, and second, that even without using such control, Union, as admitted by Memphis (Brief, p. 23), had profits in 1958 sufficient to itself absorb over one-half of its losses from 1957-61. If it had been necessary, *all* losses could have been offset. As Mr. Dunn testified (I R. 100):

> Furthermore, of course, Union being a producing company, its tax deductions are controllable. Union can control how many wells it drills in any year, and one of the main items of tax deduction is well drilling expense, both producing wells and non-producing wells, and in any given period of time Union can control to a very large extent how many wells it drills, so that there is no reason whatever to assume that Union Producing Company, being a highly successful production company and with large gas and oil reserves, proven oil reserves, would ever be in a position of not being able to utilize its tax deductions.

It is clear that the Commission erred in reducing United's rates to reflect a tax "saving" when, in fact, no tax saving was realized by the Corporate Group by use of the consolidated return. The Commission's brief argues that the "carryover, carryback" provisions of the Internal

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(*) I R. 71-72.

Revenue Code are not available to an individual company like Union if it participates in a consolidation. That is an artful, but irrelevant, argument. The Commission is trying to reduce United's rates by use of Union's losses *because,* the Commission says, *the consolidated tax return* produces a tax saving *which United, in part, makes possible by enabling there to be a consolidated return.* But, as just shown, the fact is that the consolidated return produces no tax offset which could not have been achieved *by Union alone,* if the system had chosen to do it by carryover and/or carryback, rather than through a consolidated return. Since the income of United and Parent Corporation was thus not actually needed in order to allow Union to take tax advantage of the losses it sustained, the Commission's primary "practical" argument for its unlawful "effective consolidated tax rate" theory is not only legally insufficient, but is also groundless.

3. *Petitioners' Claims Based On Inter-Corporate Finances Are In Error.*

In another effort to show irrelevant "relation" of United and the loss companies, the Commission, at pages 20-21 of its Brief, argues that United's profit "furnishes an important cushion against entrepreneurial risks" in such fields as oil and gas production. This argument ignores two facts. First, United's jurisdictional revenues are set by the Commission at a "just and reasonable" level *for pipeline* operations.(*) No extra amount is allowed because there is a producer affiliate in the Corporate Group. Second, the Commission admits (Brief, p. 21) that it is

(*) This assumes that the predicted sales will, in fact, be made at that rate level, so that profits will be realized. This is not guaranteed.

Parent Corporation, not United, which invests in Union. Thus, if any of United's pipeline profits are invested in Union's activity, it is because funds which were paid to Parent Corporation as dividends, and thus could have gone to stockholders of the parent as dividends out of profits, were instead reinvested. Merely because Union and Overseas suffered losses in their operations conducted with funds of Parent Corporation's stockholders hardly provides a reason to reduce *United's* rates.

The Commission (Brief, p. 21) also argues that the presence of Union in the Corporate Group increases the capital costs of United. In fact, the Commission, in United's rate case used *Parent Corporation's* cost of capital because it was *lower* than United's. (*United Gas Pipe Line Co.*, 25 F.P.C. 26, 110 (1961)). Since Union affects Parent Corporation's capital costs, the Commission's argument herein is obviously false. Memphis argues, contradictorily, that United's presence in the Corporate System lowers Union's capital costs. But the fact is that the Commission used Parent Corporation's cost of capital for *Union*, too, in Union's rate case. (31 F.P.C. at 74).

4. *United's Status As A Customer Of Union Does Not Justify Reductions Of United's Rates, Since United's Ratepayers Do Not Pay The Expenses Which Produce Union's Losses.*

The Commission "proves" too much when it next argues (Brief, p. 21) that, since United is a large customer of Union, the purchase of Union's gas by United means that Union's costs "are ultimately borne by United's ratepayers." If this argument were significant, it would mean that *every* large customer of a gas producer should have its rates set on the basis, at least partially, of the profits

or losses of its suppliers, so that United's rates would be affected by the fortunes of each of its suppliers. This, of course, is ridiculous, and is not, and could not be, done. In fact, however, the salient point is that in Union's rate cases, its jurisdictional rates are based only on its jurisdictional gas expenses—not its oil expenses—so that United pays none of the expenses which produce the oil losses. (31 F.P.C. at 48-49, 71-73).

The arguments of the Commission and Memphis are all directed to attempted creation of the illusion that United's ratepayers were participants in the ventures that were responsible for the losses sustained by United's fellow subsidiaries. The arguments, if logically extended, should also suggest that as a matter of equity, those ratepayers should be bearing the burden of the expenses which produced those losses of those non-jurisdictional affiliates. But the Commission does not suggest this—that United's ratepayers should support Union's oil exploration activities or Overseas' oil exploration efforts in Tunisia, for example.

The Commission and Memphis are correct when they say that the tax reductions involved herein arise because non-jurisdictional affiliates have losses. They err, however, in saying that United and its ratepayers somehow contribute to those losses, somehow share those losses with the stockholders of Parent Corporation, and somehow should benefit from them in the form of reduced rates. In fact, the losses incurred by United's non-jurisdictional affiliates in no way affect United's jurisdictional rates.

The Commission claims, however, that it is not unfair to seize the tax benefits from losses suffered by risk taking affiliates because the system stockholders (the Com-

mission claims) do not pay for *all* of the operations which produce those losses. The Commission (Brief, p. 23) says this is because United's ratepayers pay the expenses of United's operations, which include the cost of gas purchased from Union, which costs produced the losses of Union. This overlooks the fact that United points out in its brief that Union's gas operations, *which are the only ones which could even possibly "affect" United's gas costs,* since only gas costs are reflected in Union's jurisdictional gas rates, *do not produce a loss.*

5. *United Increased The Group Tax By 52% Of United's Income.*

Finally, the Commission and Memphis argue that United's tax allowance cannot be based upon the statutory 52% rate, because, they claim, no company in a system which files a consolidated return has a "separate tax liability." (Commission Brief, pp. 23, 24; Memphis Brief, pp. 23-27) This is irrelevant because neither presentation can refute the central fact of this case. *Because United is included in the consolidated tax return filed by the Corporate Group the actual total tax paid by the group is higher—by 52% of United's income—than it would have been if United were not included.* Thus, since United's jurisdictional operations "cost" the Corporate Group 52% of the income from those operations, it is not only equitable, but completely normal, that the jurisdictional ratepayers should pay that expense, just as they pay the other jurisdictional expenses. It is this concept which the Tenth Circuit expressed in *Cities Service* (adopted by the Fifth Circuit, below) when it said:

> The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its

tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52 percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion of the Gas Company in the consolidated return increased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.(*)

IV.

JUDICIAL, AND EVEN FEDERAL POWER COMMISSION, AUTHORITY OPPOSES THE COMMISSION'S "CONSOLIDATED EFFECTIVE TAX RATE" THEORY.

As noted, the only two federal courts which have considered a "consolidated effective tax rate" theory "allocating" losses of affiliates to reduce the rates of the jurisdictional company have reversed the Commission—in these *United* proceedings and in *Cities Service, supra.* Neither

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(*) 337 F.2d at 100. Footnote table omitted. Similarly, at the Commission level in *Cities Service,* two of the five Commissioners held that the pipeline's inclusion in the consolidated return increased the Corporate Group's tax by 52% of pipeline income so that the Parent Corporation had no tax advantage from such inclusion. 30 F.P.C. 158, 174 (1963).

the Commission nor Memphis have been able to cite contrary federal authority. Each, however, have alleged that the Commission has consistently utilized that theory. Even if accurate, that, of course, would not be controlling herein. The fact is, however, that prior to *Cities Service* and *United*, the only case in which the Commission considered whether it could reduce the rates of a jurisdictional company by use of losses suffered by the unregulated operations of an affiliated company—in that case the pipeline's parent—was *Olin Gas Transmission Corp.*, 17 F.P.C. 695 (1957). And in that case, the Commission refused to adopt a "consolidated effective tax rate" theory.

None of the other Commission cases(*) cited in the Commission's Brief herein, at page 14 (and Memphis' Brief, p. 15) involve losses of affiliates being used to decrease the pipeline's rates, and those cases are thus inapposite. In the interest of brevity, Natural and Texas Eastern here adopt Section III of the brief of *amicus*, Independent Natural Gas Association of America, herein, which discusses, and disposes of, those cases. That section of the *amicus* brief also demonstrates that the Court of Appeals position herein has been widely adopted in State regulatory proceedings.

(*) The only possible exception is *Home Gas Co.*, 13 F.P.C. 241 (1954), which does mention losses of affiliated, *jurisdictional* companies. It appears obvious that the Commission itself did not consider that case as precedent when subsequently it was faced with the question of benefits of tax losses of affiliated, but *non-jurisdictional* companies. See *Olin Gas Transmission Corp., supra.*

V.

THE COMMISSION'S "CONSOLIDATED EFFECTIVE TAX RATE" METHOD FRUSTRATES THE PURPOSE OF THE CONSOLIDATED RETURN PROVISIONS OF THE INTERNAL REVENUE CODE.

The Commission devotes pages 25-27 of its Brief to protests that its "consolidated effective tax rate" method is not inconsistent with the section of the Internal Revenue Code (26 U.S.C. § 1501) which allows the filing of a consolidated income tax return. But in so stating, the Commission's brief itself discloses that the contrary is true. The Commission admits (Brief, p. 26):

> Congress, in other words, desired to permit equal tax treatment between concerns that transact business through departments of a single corporation and those operating through subsidiary corporations.

That statement is quite true. And if the "United system" were a "single corporation", there would be no question but that United's tax allowance, to be included in its jurisdictional pipeline rates, would be computed by use of the statutory 52% tax rate.(*) There would be no "consolidated tax saving" for the Commission to attempt to use to reduce United's rates. But in this case, because a separate company corporate form is used, so that a

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(*) At page 19 of its brief, Memphis seems to disagree, citing *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (5th Cir. 1960), where the Fifth Circuit upheld Commission use, in setting *El Paso's* rates, of tax deductions (for statutory depletion and intangible well-drilling costs) growing out of *El Paso's own natural gas production*. Since *El Paso* dealt with tax deductions from the *jurisdictional gas* operations of the jurisdictional company itself, and not with *non-jurisdictional* oil, overseas and intrastate gas operations, it is not in point in this case.

consolidated tax return is appropriate, the Commission is attempting to take away the current tax reduction, even though the Commission admits that the purpose of the Internal Revenue Code consolidated tax return provision is to treat multi-entity and single entity businesses equally.

The fact is that Congress passed the consolidated tax return section of the Internal Revenue Code so that multi-company corporate systems would be just as able to offset losses in some operations against gains in others, in the year of such losses, as are single-company corporate systems, *and in that way attempted to give the same encouragement to multi-entity systems to carry on risk-taking, investment producing enterprises, to stimulate the national economy.* The Commission's "consolidated effective tax rate" procedure frustrates that purpose by stripping the offset benefits away from multi-company systems if *any* member of the system is subject to Commission jurisdiction. This would mean that a non-jurisdictional company with a jurisdictional affiliate would be at a severe competitive disadvantage compared to a single company competitor, which further stifles incentive for risk-taking and puts multi-company entities at a severe disadvantage. Commissioner Woodward wrote, for himself and Commissioner O'Connor, in dissent against the three man majority in *Cities Service*:

> The Opinion and Order adopted by the majority is based on the false premise that, as to industries regulated by it, the Commission has the authority to limit the effect of a mandate of Congress as expressed in Section 1501 of the Internal Revenue Code. Depriving Gas Company of a tax allowance which would be routinely granted to it by the Commission if it were not for its having a common owner with an unregulated and unrelated petroleum business, should not be done without some very persuasive reasons based

upon sound rate-making policies which impose no confiscatory rates, which balance equitable consumer and investor interests and which take fully into consideration the impact of such action upon national economic policies. At the root of regulation is economic policy. The problem of economic growth in the United States is crucially important and inseparably related to economic growth is investment. Under the majority view, the consolidated return would not result in stimulating investment and growth because it has the effect of converting non-jurisdictional losses within the parent company's system into a rate reduction for gas consumers. The majority opinion is not supported by persuasive reasons based on sound policy.(*)

CONCLUSION.

The only two Courts of Appeals which have considered the question involved in these proceedings have held the Commission to be in error. One such holding was the decision of the Court of Appeals, below. It should be affirmed.

Respectfully submitted,

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(*) 30 F.P.C. at 172.